No. 78-956

IN THE
Supreme Court of the United States
October Term, 1978

BERNARD JAY COVEN,
Petitioner,

-against-

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Petitioner's Supplemental And Reply Brief

BERNARD JAY COVEN P.C.
Attorneys for Petitioner
777 Third Avenue
New York, N.Y. 10017
(212) 758-7090

BERNARD JAY COVEN
Of Counsel

DICK BAILEY PRINTERS, 290 RICHMOND AVE., S.I., N.Y. 10302
TEL.: (212) 447-5358

TABLE OF CONTENTS

TABLE OF CASES

IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1978

No. 78-956

BERNARD JAY COVEN,
Petitioner,

-against-

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

PETITIONER'S SUPPLEMENTAL AND REPLY BRIEF

STATEMENT

The Respondent's "Statement" is misleading in several instances. The portion of the injunction before this Court on this petition solely relates to Rule 10b-9 which portion was affirmed by the Court of Appeals (P. App. 1a-3a).[1] The language employed to enjoin petitioner is, in haec verba, that of Rule 10b-9. The statement found in Note 11 of Respondent's Brief (P. 9) to the effect that the injunction remaining after the decision of the Court of Appeals incorporated the prohibitory language of §17(a), is in error. Another misleading reference appears in the first full paragraph of page 9 of Respondent's Brief, stating that the first cause of action of the Commission's complaint expressly charged that petitioner violated §17(a). The first cause of action was not sustained as against the petitioner. The District Court found that the underwriter, in improperly

[1] P. App. refers to Petitioner's Appendix.

representing "that the offering would be an "all or none" basis, violated Rule 10b-9 as well as 10b of the 1934 Act" (P. App. 46a) and held the petitioner as an aider and abetter of such violation. The District Court submised that the underwriter had "contrived figures calculated to give the appearance that the minimum portion of the issue had been sold" (P. App. 46a). The District Court did not find that the petitioner knew or had the ability to determine that the underwriter's figures were "contrived." Indeed, the figures if "contrived" did not invite inquiry as the issuer, petitioner's client, received the proceeds of the sale of 73,500 shares *in excess* of the minimum for which the issue was paid in full. (P. App. 57a). The statement, contained on page 5 of the Respondent's Brief (first full paragraph), that petitioner had been enjoined by the District Court from violating various provisions of the Securities Laws "including Section 17(a) of the Securities Act" is, again, in error. The petitioner was, prior to reversal by the Court of Appeals, enjoined from further violations of Rules 10b-5, 10b-6 and 10b-9. Those violations and related portions of the injunction with respect to 10b-5 and 10b-6 were reversed by the Court of Appeals. It is the application of the law to §10b, as implemented by Rule 10b-9 that is before this Court.

ARGUMENT

1. There is no dispute that the District Court held the petitioner to be an aider and abettor of a violation of §10b "as implemented by Rule 10b-9" (R. Br. pp. 3-4).[2] The Respondent argues that while petitioner was not found by the District Court to have aided and abetted a violation of §17(a) nonetheless, petitioner violated §17(a). Respondent argues that this is so because §17(a) is broader in scope than §10(b) (R. Br. p. 8). This conclusion is both unsound and lacking in logic. For one, petitioner can hardly be held to have aided and abetted a violation

[2]R. Br. refers to Respondent's Brief.

which had not been found to have been committed by the person said to have been aided and abetted. The respondent avoids the difficulty of legal argument by simply stating, *ipse dixit,* that "[P]etitioner violated Section 17(a) of the Securities Act of 1933" (R. Br. p. 8). The respondent does not descend from the general to the particular . Nowhere in the brief of respondent is there any reference to any particular subsection of §17(a), ignoring the various treatment of each of these subsections by the Courts as indicated in petitioner's Main Brief at pp. 10-16 and supplemented herein. In arguing that the "provisions of Section 17(a) cast a broader net than does Section 10(b)" (R. Br. p. 8) respondent concludes "that they therefore do not require proof of intentional misconduct." Both the premises and conclusion are in error. Section 10b and Rule 10b-9, which implements it, are broader in scope than §17(a). Section 10b employs the phrase "*in connection* with the purchase or sale" and 10b-9 employs the phrase "*in connection* with the offer or sale." §17(a) restrictively refers to "*in* the offer or sale." See, *Financial Programs, Inc. v. Falcon Financial Services, Inc.*, 371 F. Supp. 770 (D. Oregon 1974). In *SEC v. Penn Central,* CCH Sec. L. Rep. ¶96,461, page 93,640 (E.D. Pa. 1978) Chief Judge Lord opining on the distinction stated:

> Section 17(a) of the Securities Act of 1933, by contrast, reaches only fraud "in the offer or sale" of securities. Quite clearly, the omission of the words "in connection with" makes the scope of §17(a) narrower than that of §10b in that the former requires a closer relationship between the fraud and the securities transaction.

In similar view, the Court in *Resource Investors Group v. Natural Resource Investment Corp.,* CCH Sec. L. Rep. ¶96,752, p. 94,944 (E.D. Mich. 1978), said:

> Several recent cases have held that conduct occurring after a sale cannot be the basis of liability under section 10(b) or Rule 10b-5. Onashi v. Verit Industries, 536 F.2d 849 (9th Cir. 1976); Wolford v. Equity Resources Corp., 424 F. Supp. 670 (S.D. Ohio 1976); Kogan v. National Bank of North America, 402 F.Supp. 359 (E.D.N.Y. 1975). * * *

Section 17(a) of the Securities Act of 1933 is even narrower than Rule 10b-5 in that the fraud must actually be in the offer or sale itself, rather than in connection thereto.

It also may be noted that Rule 10b-9 contains the words "offer or sale" as does §17(a). It would thus appear that §10b as implemented by Rule 10b-9 is, thus *a fortiori,* broader in scope than §17(a).

There is a further question left unresolved by respondent, the application of §17(a) "offer or sale" to the facts of this case. The disputed closing did not involve an "offer or sale" within the meaning of §17(a). See, *SEC v. Savoy Industries, Inc., et al,* CCH Sec. L. Rep. ¶96,497, p. 93,876 (D.C. Cir. 1978); *Resource Investors Group v. Natural Resource Investment Corp.,* cited supra.

2. Conflicts continue in the various circuits with respect to whether scienter must be alleged and proved against one charged as an aider and abettor both under §10b and §17(a). In *SEC v. Blatt, et al,* 583 F.2d 1325 (5th Cir. 1978), the Court held that scienter is required to be alleged and proved in 10b-5 SEC enforcement actions, citing this Court's opinion in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). The opinion noted that since Congress did not contemplate private actions under this section, it follows logically that the scienter requirement implicit in the statute must have been intended for SEC enforcement actions (Note 21). In *SEC v. Willis,* CCH Sec. L. Rep. ¶96,712 (D.C. 1978) the Court held that *Hochfelder* required proof of scienter in §10b SEC enforcement actions. The Court held that with respect to §17(a)(3) negligence would sustain a *finding* of violation. However, with respect to the *issuance of an injunction,* the Court considered whether there was proof of scienter and finding none, denied the SEC an injunction. The Court cited the instant case for its determination that negligence would support an injunction under §17(a)(3). In connection with this it is difficult to comprehend how one under §17(a)(3) can commit a fraud or deceive another without the required intent. It is evident that in the absence of a determination by this Court of the

applicability of *Hochfelder,* the Court in *at illis* was unwilling to hold that scienter played no part in the issuance of an injunction.

3. The finding by the Court of Appeals that the conduct of the petitioner "amounted to a kind of reckless disregard" was erroneous as it did not meet an equivalent criteria of scienter. The Court of Appeals cited *Rolf v. Blyth, Eastman Dillon & Co.,* 570 F.2d 38 (2nd Cir. 1978). In *Rolf* the Court, although using the term "reckless," held that *gross* negligence *plus* the violation of a fiduciary duty was sufficient to sustain a 10b-5 action for damages. The Court emphasized the fiduciary duty of the defendant, stating that it did not reach the question of "recklessness" which satisfies the scienter requirement, absent the presence of a fiduciary obligation (note 9). In the instant case there was no fiduciary obligation involved. In *Berman v. Richford Industries,* CCH Sec. L. Rep. ¶96,518 (S.D.N.Y. 1978) The Court stated that the negligence standard posited by the *Rolf* Court was, absent the presence of a fiduciary obligation, not "recklessness." Other *Rolf* citations have emphasized the fiduciary obligation in discussing whether the truncated version of the Second Circuit should be applied in their Circuits. See, *In re Gap Securities Litigation,* CCH Sec. L. Rep. ¶96,709, pp. 94,750, 94,751 (N.D. Cal. 1978); *Resource Investors Group v. Natural Resource Investment Corp.,* cited supra.

4. The District Court found in the case at bar that to aid and abet, "knowledge that a violation is being committed and intent to further the illegal act is not required" (P. App. 49a), and applied a negligence standard. The Court of Appeals in its partial affirmation approved this standard. *Hochfelder,* it is submitted, required of the Court a different reading. The conclusion of the Court of Appeals appears illogical in any event. As was stated by the Fifth Circuit in *Woodward v. Metro Bank of Dallas,* 522 F.2d 84, 95 (5th Cir. 1975), citing *SEC v. Coffey,* 493 F.2d 1304, 1316 (6th Cir. 1974) cert. den. 420 U.S. 908 (1975):

> The scienter requirement scales upward when activity is more remote; therefore, the assistance rendered should be both substantial and knowing. A remote party must not only be aware of his role, but he should also know when and to what extent he is furthering the fraud.

See, *Resource Investors Group v. Natural Resource Investment Corp.*, cited supra (absent the factors of knowing and substantial assistance precludes any secondary liability for the violation of others citing *SEC v. Coffey*, supra). In *Monsen v. Consolidated Dressed Beef Company, Inc.*, 579 F.2d 793 (3rd Cir. 1978), the Court stated:

> Knowledge of the underlying violation is a critical element in proof of aiding and abetting liability, for without this requirement financial institutions, brokerage houses and other such organizations would be virtual insurers of their customers against security law violations . . . mere unknowing participation in another's violation is an improper predicate to liability.

a statement which is equally applicable to enforcement actions where the consequences are more severe. In the instant case there was neither proof, claim nor finding that the petitioner was aware that the underwriter had contrived the number of shares sold by it. The District Court found here that the petitioner had a "cavalier attitude' (P. App. 50a bottom).

5. The cases cited by the respondent (R. Br. p. 7) are either inapposite or serve to underscore the conflict in the Courts of the various Circuits as to the application of *Hochfelder*. *American Realty Trust* and *World Radio Mission*, both cited by the Respondent, have been treated in Petitioner's Main Brief (pp. 12, 13). Respondent also cites to *SEC v. Pearson*, 426 F.2d 1339 (10th Cir. 1970) and *SEC v. Van Horn*, 371 F.2d 181 (7th Cir. 1966). Both *Pearson* and *Van Horn* were decided sometime prior to this Court's decision in *Hochfelder*. Both involved an application for a preliminary injunction and both involved the sale of unregistered stock, a violation of §5 of the 1933 Act, as to which no intent to violate need be shown. *Pearson* cited and relied on *Van Horn*. In *Pearson* an application for a preliminary

injunction was denied and the case dismissed without trial. The denial was affirmed but the action was restored for hearing on the merits. *Van Horn* has been overruled by *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977) (referred to in petitioner's Main Brief, p. 12). *Sanders* was decided after remand by this Court for reconsideration in the light of *Hochfelder*. The Securities and Exchange Commission appeared in *Sanders* as amicus curiae. The respondent's statement that petitioner's reliance on the cited case is "unwarranted" (R. Br. p. 7) is absurd. The case is squarely on point.

6. In *Hochfelder* this Court expressed its concern that individual sections of the 1933 and 1934 Acts be interpreted as part of a consistent scheme of regulation. The holding of the Court of Appeals in the instant action does violence to such expression. If scienter is not to be required for enforcement actions under §17(a) and if private actions for damages are recognized under that section (as several circuits have already held), the effect would be to negate limitations on private recoveries for negligence contained in §§11 and 12 of the 1933 Act (P. App. 19a). The Court of Appeals here recognized this conflict but added that the issue of whether there is an implied right of private action under §17(a) was open in the Second Circuit.

7. It is submitted that upon reversal of a major portion of the injunction the Court of Appeals erred in failing to remand the action to the District Court for a determination as to whether or not the District Court would issue an injunction in light of such substantial reversal. The District Court which heard and could assess the credibility of the witnesses, particularly of the Petitioner, has broad discretion in the issuance of injunctive relief in SEC actions. It is one thing to have been held to have gone astray in connection with one aspect of one transaction and it is another to have been guilty of three violations in connection with the same public offering. The District Court on remand might well have determined that an injunction against the petitioner attorney was not warrnted. The petitioner

was unfairly deprived of such opportunity. An injunction is a harsh remedy and against an attorney, harsher yet. As the Court in *SEC v. Blatt,* cited supra, note 28, stated, experience has shown that an injunction is much more than a 'mild prophylactic', a term often used by the respondent.

The Court in *Hecht Co. v. Bowles,* 321 U.S. 321 (1944), at page 329, said:

> The historic injunctive process was designed to deter, not to punish. The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy are practical and have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs . . .

CONCLUSION

The application herein presents meritorious questions of a kind which require determination by this Court. As indicated there are sharp conflicts of opinions in the Courts of the various Circuits as to the application of this Court's opinion in *Hochfelder* and such questions are likely to arise in other cases.

For the foregoing reasons, your petitioner respectfully prays that a Writ of Certiorari issue to the United States Court of Appeals for the Second Circuit to the end that this cause may be reviewed and determined by this Court and so much of the said judgment of the Court of Appeals as affirmed a judgment of the District Court be reversed and for such other, further and different relief as may be just.

Dated: New York, New York
February 21, 1979

Respectfully submitted,

BERNARD JAY COVEN, P.C.
Attorneys for Petitioner
777 Third Avenue
New York, N.Y. 10017

BERNARD JAY COVEN
Of Counsel